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International Economic & Energy Weekly [redacted]

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22 April 1983

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Comments and queries regarding this publication are welcome. They may be directed to [redacted] *Directorate of Intelligence* [redacted]

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Synopsis

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Deepening economic and financial problems and mounting domestic pressures are sharply raising the risk that Mexico will not be able to meet midyear IMF targets. [redacted] 25X1

Israel: Bleak Economic Prospects [redacted] 25X1

An unwillingness by Israeli policymakers to bite the austerity bullet, high defense expenditures, and the unfavorable international economic situation will combine again this year to buffet the Israeli economy. This continued poor economic performance will result in Israel's pressing the United States for even more aid and better terms to bail them out. [redacted] 25X1

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Bolivia: The Cocaine Industry [redacted] 25X1

During the last decade, Bolivia has emerged as a leading producer and exporter of coca paste and base. Cocaine from Bolivian coca supplies roughly 40 percent of the 35 to 45 tons consumed each year in the United States. Although the government of Hernan Siles Zuazo has pledged to eliminate drug trafficking in Bolivia, he probably will be too occupied with consolidating his hold on power, fending off military and civilian critics, and grappling with Bolivia's current economic crisis to implement an effective antinarcotics program. [redacted] 25X1

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Perspective

Mexican Economic Trends

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Deepening economic and financial problems and mounting domestic pressures are raising the risk that Mexico will not be able to meet midyear IMF targets.

President de la Madrid's efforts to bring Mexico's massive foreign debt under control without derailing the domestic economy have yielded mixed results. Foreign purchases have been slashed by steep peso devaluations and the IMF austerity program. This has boosted Mexico's trade surplus and pushed its current account toward balance, but the government has not been able to rebuild reserves or reduce debt arrearages because some capital flight continues. We believe that imports will remain drastically reduced at least through August because of continuing financial problems.

Meanwhile, industrial production is off dramatically and local supplies of goods are dwindling. Shortages of imported raw materials have caused manufacturers to shut down numerous factories, and some industries report that production had dropped as much as 65 percent. Private-sector estimates place unemployment up sharply to 20 to 30 percent. While no official statistics are available, based on import trends and partial industrial statistics, we believe economic activity fell at an annual rate of 5 to 10 percent during January through March.

Inflation remains high despite falling GDP and rising unemployment. The soaring peso cost of imports, higher wages, and mounting consumer goods shortages continue to be the largest factors in price increases. Inflation, which started the year at a 240-percent annual rate in January because of price decontrols and subsidy cuts, fell to an average 90-percent annual rate in February and March. We expect inflation to rebound somewhat in April, in part because of lower subsidies on fuels and some foods.

Cuts in government spending, multiplying bankruptcies and unemployment, and the drop in oil prices have hindered restoration of public confidence. Mexicans are nervous about the future and doubtful that the administration can quickly restore prosperity. The President's failure to prosecute former officials accused of corruption has increased skepticism about his commitment to change. The ruling party is trying to improve its own reputation to build support for de la Madrid and offset criticism that the poorest sectors are suffering most. Watchdog committees have been established to protect consumers, and others to monitor corruption are envisioned.

Although most interest groups remain quiet, organized labor appears increasingly restless. The unions have not abandoned the four-month-old labor-government-management solidarity pact, but recent increases in milk and gasoline prices have prompted demands to implement rent controls and to move forward—or increase—a pay raise promised for this summer. Indications are strong that de la Madrid will try to mollify labor by advancing the wage hike. This would, however, rekindle fears in the business community of a return to Lopez Portillo's antibusiness policies, and probably encourage de la Madrid to offset in part the higher wage bill by offering business some combination of increased producer subsidies, access to easier credit, and new tax incentives.

On the financial front, many commercial bankers believe de la Madrid is not taking sufficiently firm austerity measures. Because of the delays in arranging the $5 billion commercial credit and overwhelming legal problems, progress in addressing debt service problems has been slow. Mexico City has asked its creditors for a second extension—to 15 August—of the moratorium on repayment of public-sector principal.

The private sector has been unsuccessful in reducing its debt arrearages, in part because the government has favored the public sector in allocating foreign exchange. The government now plans to establish a program to rescue at least the more stable firms from foreign insolvency. Even so, we believe that most private rescheduling agreements will have to wait until the complicated process of rescheduling the much larger public-sector debt is completed.

Although IMF officials, citing preliminary data, have indicated that Mexico was in compliance with its stabilization program through March, we believe de la Madrid has backed away from the letter of the agreement by tempering domestic austerity with concessions to labor, business, and the middle class. Investment in the public sector has been reduced, but the government work force has grown and large subsidies remain on at least 300 basic consumer goods and services. Moreover, the nationalized banks have kept interest rates significantly below the inflation rate.

The steep economic downturn is further undermining Mexico's ability to meet terms of its stabilization program. Private-sector economists, citing government statistics, point out that the plunge in commercial activity and lower oil sales kept government revenues substantially below target in January and February. Inflation, currently twice the rate projected by the stabilization program, has halved the real level of available domestic financial credits. As a result, we believe that by midyear Mexico City is likely to seek an adjustment in IMF constraints on the public-sector deficit, money supply expansion, and overseas borrowing to hold the fall in employment and consumption to politically acceptable levels.

Nevertheless, international bankers probably will be reluctant to provide additional credit or to offer relief on interest obligations. Mexico, consequently, is likely to ask Western nations and international financial organizations to increase their lending. Without additional voluntary international funding, de la Madrid may face the difficult choice of expanding the current moratorium on principal payments to include interest obligations or face growing domestic turmoil kindled by a deepening depression. Some opposition leftist politicians and intellectuals have recently demanded such an interest moratorium, while others are calling for a more general debt repudiation.

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Briefs

Energy

Iraq Lowers Oil Transport Fees

To encourage oil sales, Iraq has reduced its transport fee to 35 cents per barrel—effective 1 April—on crude oil delivered to the Mediterranean. Before OPEC's price realignment last month, the charge had been 65 cents per barrel for oil delivered [redacted] 25X1

Explosion at Indonesian LNG Facility

LNG production at Indonesia's Bontang facility in East Kalimantan was disrupted on 14 April by an explosion at one of the plant's two existing gas liquefaction trains. The plant accounted for nearly half of Indonesia's $2.6 billion of LNG exports in 1982. Until the plant is repaired—which will take at least two months—Pertamina is likely to lose about $1 million a day. In addition, the accident could delay the planned doubling of the plant's capacity by nearly a year. [redacted] 25X1

International Trade, Technology, and Finance

Toyo Kogyo–Ford Negotiations for Joint Production of Autos in United States

According to a trade journal, Japanese automaker Toyo Kogyo and the Ford Motor Company recently renewed negotiations for the joint production of subcompacts in the United States. No details have been provided concerning the volume of the proposed project. Talks on the joint venture point to a trend of increasing reliance by US automakers on Japanese manufacturers for small cars to fill out the low end of product lines. [redacted] 25X1

Proposal To Expand Trade Authority of EC Commission

The EC Commission has approved and sent to the EC Council a proposal that substantially expands the Commission's trade policy authority. Modeled after Section 301 of the US Trade Act of 1974, it would give the Commission authority to receive complaints directly from Community industries and governments regarding the trade practices of other countries. Limited to "unfair" practices that contravene the GATT or accepted international trade rules, such authority is now held to a lesser degree by the Council of Ministers. The proposal gives the Commission authority to unilaterally adopt tariff increases, suspend tariff preferences, and adopt antidumping measures in response to GATT violations by third countries. [redacted] 25X1

The proposal essentially is in response to French demands for a quicker and more effective defense of Community trade policy interests, and also is supported by Italy, Greece, and to some extent Belgium. France has indicated that the existence of such legal measures would be a trump card with which to deal with Japan and the United States. The Netherlands, Denmark, and West Germany, however, oppose the measure arguing that the protectionist nature of the proposal would invite retaliation and that serious economic problems with the United States and Japan should be solved through consultations. Furthermore, these countries fear that a transfer of authority from the Council to the Commission will diminish the ability of member states to restrain the Commission, which would be pushed by France and others to accept trade complaints. [redacted] 25X1

EC Commission Will Seek Lower OECD Consensus Rates

The EC Commission, under mandate from the Community's finance ministers, will propose a reduction in OECD export credit consensus rates at next week's OECD meeting. The proposal calls for a moving consensus rate—the present rates are fixed and adjusted periodically—tied to a weighted average of interest rates in the five countries whose currencies make up the SDR. The French who support a 2-percentage-point reduction, are adamant about creating a mechanism that allows the consensus rate to move in line with market rates. A moving rate for export credits would help alleviate the incentive for countries to undercut the present fixed rate structure because export credit rates would more closely approximate market rates. [redacted] 25X1

Chinese Cutoff of Wheat Purchases From the United States

China's continuing refusal to buy US wheat reflects Beijing's unhappiness with high US grain prices and its current dissatisfaction with US foreign policy. [redacted] 25X1 China has been the largest market for US wheat, purchasing nearly 7 million tons in 1982. Since late last year, however, the Chinese have been inactive in the US wheat market. [redacted] 25X1

The recent US decision to grant asylum to tennis star Hu Na and negotiations for a new textile agreement probably played a role in the Chinese move, although Chinese traders previously have cited bilateral trade and political issues as the cause for not purchasing commodities when, in fact, economic reasons apparently were paramount. Moreover, the recent high prices of US grain have made Argentina's bumper grain harvest and the EC's subsidized stocks a better buy for the Chinese. If US wheat prices undergo a normal decline in late spring, the Chinese are likely to resume purchases of US wheat within the next 30 to 45 days. With a price decline, they probably still will meet their commitment to purchase at least 6 million tons of wheat and corn under the bilateral long-term grain agreement. [redacted] 25X1

Possible Dispute Over Chinese Tungsten Exports to United States

The emergence of China over the past three years as the United States's leading supplier of tungsten compounds has led to calls from US producers for restrictions on such trade. A Chinese metallurgical industry official has stated that China has no plans to increase tungsten production in the near future, but he avoided committing China to a specific level of exports. China's Ministry of Foreign Economic Relations and Trade has promised to take steps to avoid a further disruption of the US market, but it no longer has a monopoly on China's tungsten exports. Local Chinese producers not under Ministry control will no doubt resist efforts to curb their profitable trade. Although the Chinese have appeared more forthcoming than during the negotiations over textiles, we believe their responses are mainly aimed at delaying unilateral action by the United States. [redacted] 25X1

Reduced Cuban Sugar Sales

Cuba reportedly will cut sugar exports to other Communist countries because of crop losses from weather damage. Havana has not yet failed to make deliveries under long-term contracts with the West, but it is buying sugar on the open market at the current low prices to cover these commitments. [redacted] the sugar harvest this year is not expected to exceed 6.5 million tons, well below the 8.2 million tons reported in 1982. Nevertheless, the USSR is demanding at least 4 million tons of sugar from Cuba. [redacted] 25X1 25X1 25X1

Cuba is likely to continue buying sugar in an effort to retain its contracts with Japan, Canada, and other important customers. It needs to sell sugar in the West to meet the foreign exchange targets set in its recent debt rescheduling agreement. If only 6.5 million tons are harvested, Havana will be unable to deliver much more than 3.2 million tons to the USSR without jeopardizing its hard currency earnings. [redacted] 25X1

Zambian IMF Loan Approved

The IMF this week approved a $228 million one-year standby loan to Zambia. The funds are to be used largely to reduce the burgeoning commercial debt Lusaka acquired during the past several years. Zambia's foreign reserves had dwindled to a level sufficient to cover only two weeks' imports because of a sharp decline in the price of copper, which accounts for 90 percent of export earnings. The Fund is likely to monitor the government's use of the loan closely because it was unhappy that Lusaka had used IMF credits in 1981 primarily to purchase imports rather than to pay off overdue debts. The Fund reportedly has also approved an additional loan of about $100 million under the Compensatory Financing Facility, but it will probbly delay disbursement until after Zambia's Paris Club debt rescheduling, tentatively slated for mid-May. [redacted] 25X1

New UN Shipping Code

The UNCTAD Code of Conduct for Liner Conferences was finally ratified last week with signatures from West Germany and the Netherlands. The new Code, which will come into force in October, encourages trading partners to

reserve high portions of their trade for their own ships. Its most immediate impact will be felt in the movement of LDC cargoes. Much of that business will now shift from third-country cargo lines—primarily West European—to lines operated by the developing nations and their trading partners. Reduced competition will likely lead to higher shipping rates for this trade. Shipping among the developed nations will be little affected since most have agreed to ignore the Code's cargo-sharing provisions with respect to mutual trade. [redacted] 25X1

Japan: Agricultural Imports

Japanese negotiators will propose a compromise in Washington next week, relaxing but not eliminating quotas on beef and citrus. [redacted] 25X1

If the offer is close to one outlined in the press, it would extend the current US-Japan agreement, which expires in 1984, to 1987 and would continue the annual incremental increases in the quota. Tokyo probably believes the offer is the first step in a several month negotiating process. [redacted] 25X1

National Developments

Developed Countries

Australian Wage Indexation System

The economic summit last week of government, business, and union leaders agreed to reestablish a nationwide wage indexation system but left the politically tough decisions on the timing and formula for the wage increases for the Australian Arbitration Commission, which meets in June. Business and labor still have significant differences over the indexation method and the length of the current wage freeze—now scheduled to end in June. We believe Prime Minister Hawke will attempt a compromise by pushing for an extension of the wage freeze until October, followed by indexation. [redacted] 25X1

The Hawke government, however, will be under increasing pressure from unions to adhere to campaign promises to maintain real wages. The 47,000-member Building Workers Union has already voted to push for a wage increase and a shorter workweek. Excessive growth in wages, averaging 16 percent in 1980-82, is in large part responsible for Australia's high inflation and record 10.1-percent unemployment, and, unless wages can be kept under control, economic recovery will be slow at best. [redacted] 25X1

Spain Tightens Monetary Policy

The Spanish central bank has increased the reserve requirement for interest-bearing deposits by 1 percentage point in an effort to slow inflation and improve Spain's external position. The measure should help curb the growth of the money supply, which surpassed the government's target of 13 percent during the first quarter. In addition, domestic interst rates will rise, encouraging corporations to borrow on the Eurodollar market. The resulting capital inflows will help to stem the loss of foreign exchange reserves, which have fallen by over $1 billion since January. Although higher interest rates will dampen private investment and further diminish the Socialists' chances of stimulating employment, the Gonzalez administration appears prepared to accept this possiblity.

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Less Developed Countries

Singapore Gains Major Electronics Investment

Hewlett-Packard, the world's third-largest producer of small computers for business and technical use, is embarking on a $75 million expansion plan that will more than double its output in Singapore by 1986. As part of the expansion, the company will transfer some manufacturing operations now performed in the United States—such as wafer fabrication and microchip testing—to a $50 million plant that will be completed in 1985. According to a company executive, Hewlett-Packard decided to increase its investment in Singapore largely because of the high quality and reliability of the local work force.

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Indonesian Price Increases Following Devaluation

Jakarta so far is taking only modest steps to limit price increases since the 27-percent devaluation announced on 30 March. Although government officials have said they expect to hold inflation below 20 percent this year, they failed to prevent price hikes immediately after the devaluation. While some businesses in Jakarta closed the following day to mark up prices of imported goods, others took the opportunity to increase prices of domestically produced goods by 20 to 40 percent. Officials probably will act forcefully if prices continue to escalate and may temporarily prohibit increases as they did after the devaluation in November 1978.

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Nicaraguan–Costa Rican Trade Talks Announced

Despite mounting political tensions between Nicaragua and Costa Rica, officials from both countries last week publicly agreed to try to revitalize the Central American Common Market (CACM). Delegations led by junta member Sergio Ramirez and Costa Rican Vice President Alberto Fait agreed to set up a joint commission to find ways to increase bilateral trade and recommended negotiations to arrange financing for Costa Rican purchases of Nicaraguan goods. Both countries, however, are suffering from severe financial problems that will continue to limit import financing, and US Embassy reporting indicates that Managua does not attach much importance to boosting

exports to CACM. Nicaragua's participation in the economic talks is in keeping with its broader strategy of promoting bilateral negotiations on many issues within the region. Increasing border incidents could easily derail the preliminary economic accords. [redacted] 25X1

Ethiopia Receives Pledges of Soviet Economic Support

According to the US Embassy, a Soviet delegation visited Addis Ababa in early March to discuss Ethiopia's proposed $15 billion 10-year development plan scheduled to begin next year. The presence of Soviet State Planning Committee Chairman Baybakov highlights Soviet concern about Ethiopia's unhappiness with the level of Moscow's economic assistance—less than $400 million since 1974. The Soviets indicated that Moscow would provide nearly $300 million in assistance for such projects as a hydroelectric facility, dams and irrigation development, and oil and gas exploration. Most of these projects, however, have not even reached the design stage, and construction will most likely take far longer to complete than the Ethiopians anticipate. [redacted] 25X1

Controversy in Guatemala Over Economic Policy

Guatemalan officials, facing a severe shortage of foreign exchange, have announced that negotiations are in progress with the IMF for a $125 million standby loan and that a value-added tax will be imposed and large budget cuts made. Current foreign exchange reserves can barely cover imports for another two weeks, and industry could be virtually paralyzed within a few months if critical imports are unavailable. The new steps are unlikely to mute mounting criticism from influential businessmen, who fault the government for not taking these actions sooner. Businessmen also are likely to push harder for direct participation by the private sector in making economic policy. [redacted] 25X1

Threat of Famine in Bolivia

Bolivia faces an immediate and catastrophic food shortage, according to the US Embassy. Crops have been destroyed by drought on the Altiplano and in the high valleys and by flooding in the lowlands of Santa Cruz Department. Preliminary projections of the crop this year indicate the losses may exceed 1 million tons. More than half of the shortfall is expected to be in potatoes, the staple of poor farm families. [redacted] 25X1

As floodwaters recede, crops can be planted in the lowlands, but there is no prospect of substantial food production in the drought-stricken highlands before 1984. Small-farm families making up the bulk of the rural population in the Departments of La Paz, Oruro, and Potosi will face near famine conditions

Bolivia

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during the next year. Consumption of seed stocks and distress slaughter of farm animals probably will make recovery of the agricultural system difficult. The government has few financial resources with which to cope with the emergency, and international relief efforts will be complicated by limited food-storage capacities at transshipment points and inadequate transport for distribution.

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Communist

Private Meat Sales Banned in Romania

The government has banned the private sale of meat and has announced it will strictly enforce price ceilings on the private sale of all other foodstuffs. The regime is requiring compulsory registration of all livestock to help enforce the ban, with stiff penalties for those who underreport their holdings. Meat procurements by the state reportedly are running below plan, despite distress slaughtering prompted by feed shortages. The new regulations are designed to curb growing black-market profiteering during the current period of severe food shortages and excess currency in the hands of the public. They probably also are intended to assist the government's plans to export more meat to earn hard currency. If there is rigid enforcement, farmers will have less incentive to produce, and food supplies will be further reduced. [redacted] 25X1

China Buying More Soviet Timber

Chinese [redacted] will purchase 1 million cubic meters of Soviet timber this year—equal to 2 percent of China's domestic production—under a recently signed trade agreement. Desperately short of timber, China has been increasing purchases to protect its own dwindling forests. The United States has supplied most of the increase, with last year's sales jumping to 1.3 million cubic meters. Chinese purchases so far this year, however, have been declining as US timber prices have risen. The Soviets have only a limited capability to supply China with timber and therefore cannot completely replace the United States in the China market. The current deal may even include provisions for Chinese laborers to cut the timber, which will then be shipped to China by rail. [redacted] 25X1 25X1

Israel: Bleak Economic Prospects [redacted]

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An unwillingness by Israeli policymakers to bite the austerity bullet, high defense expenditures, and the unfavorable international economic situation will combine again this year to buffet the Israeli economy. Finance Minister Aridor will not achieve his goal of reducing the inflation rate to double digits, even though economic growth will remain extremely sluggish. The balance-of-payments situation will continue to deteriorate, largely as a result of Aridor's anti-inflation policies. This continued poor economic performance will result in Israel pressing the United States for even more aid on better terms. [redacted]

1982: Not a Good Year

For the first time since 1953, the Israeli economy failed to record any real economic growth last year, according to preliminary estimates by the Israeli Government. While such estimates have been subject to major revisions in the past, we believe that the GNP growth rate in real terms will not be very different when the final national accounts data are released next month. A nearly 5-percent real decline in the export of goods and services accounted for much of Israel's economic stagnation. Although domestic defense consumption rose more than 13 percent in real terms due to the invasion of Lebanon, overall government consumption fell 3 percent because of a large drop in highly volatile defense deliveries and only a slight increase in civilian consumption. [redacted]

Despite an estimated slight drop in real wages, private consumption increased 6.8 percent in real terms, fueled by the earnings from a 70-percent real gain on the Tel Aviv stock market and real rates of return averaging 3 percent on savings accounts and government bonds. Investment, rebounding from two years of negative growth, rose 6 percent. Plant and equipment investment, which had declined at an annual rate of 2 percent since 1975, increased nearly 10 percent; some of the gain may be due to a change in tax laws that eliminated the incentives for companies to purchase financial assets. Housing fell 6 percent, continuing the trend of recent years. [redacted] 25X1

Based on fragmentary evidence, it appears that Aridor was able to cover the cost of the invasion of Lebanon, estimated to be $1.2 billion by the Israeli Government. New taxes were imposed, including an increase in the value-added tax from 12 percent to 15 percent, that were designed to raise $600 million. An additional $650 million was to come from Aridor's "compulsory loan" scheme; under this arrangement—which expires at the end of this month—most workers received 4 percent of their salaries in the form of long-term government bonds with terms so poor that the bonds are, in effect, a tax. Aridor admitted to a US Embassy officer last summer that he used the war as a pretext to enact measures he believed were necessary anyway. [redacted]

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Aridor narrowly missed being tagged with a new inflation record; prices rose 131.5 percent, slightly below the record pace of 132.9 percent in 1980 and a substantial increase from the 101.5-percent rate in 1981. Price hikes accelerated early in the year as Aridor attempted to reduce government subsidies by raising prices on government-controlled commodities by larger amounts than the prevailing inflation rate. Later in the year, as inflation threatened to set a new record, Aridor adopted a policy of increasing prices of these products by a relatively modest 5 percent a month. He also slowed the depreciation rate of the shekel in order to slow the rise in import prices. [redacted]

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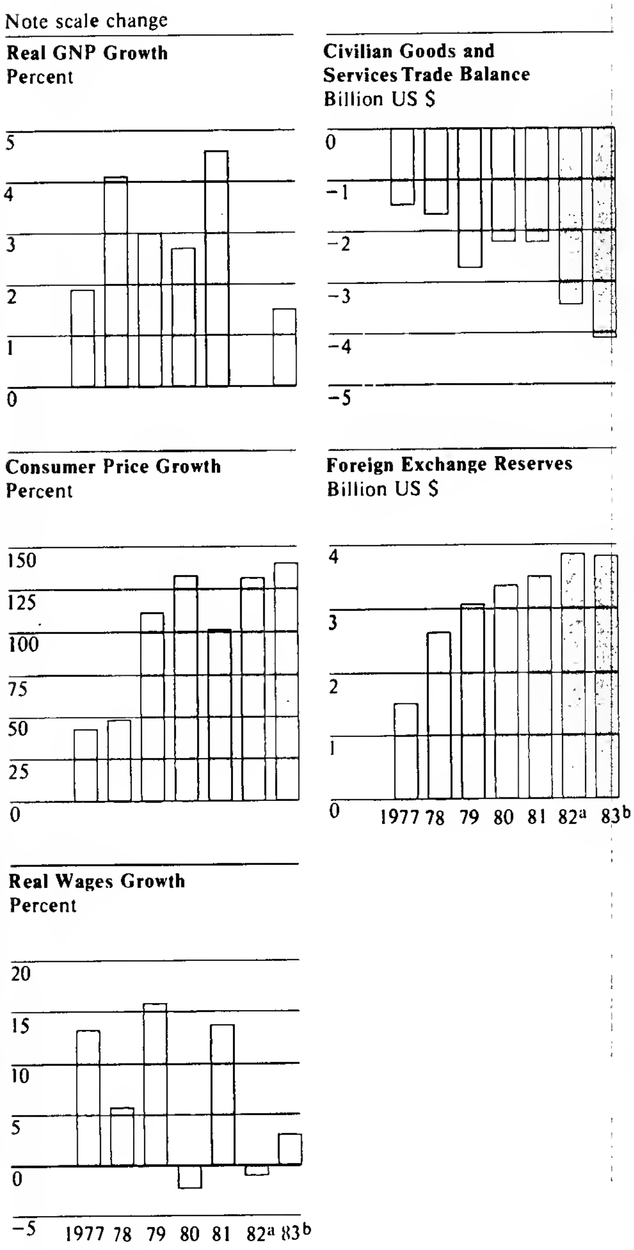
Israel: Economic Indicators



[a] Estimated.
[b] Projected.

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Israel's foreign financial gap last year rose to an estimated $5.1 billion from $2.9 billion in 1981. Although the worldwide recession contributed to the export decline, Aridor's policy of slowing the depreciation rate of the shekel made Israeli products less competitive abroad. In addition, the invasion of Lebanon and the grounding of El Al for several months resulted in a net decline in tourism of $120 million, according to US Embassy reporting. At the same time, civilian import volume increased about 8 percent, contributing to an estimated $1.2 billion increase—to more than $3.4 billion—in the civilian goods and services deficit. 25X1

Although capital account data for the year are not yet available, Israel apparently was able to finance the deficit by sharply increasing foreign borrowing, since foreign exchange reserves increased by nearly $350 million during the year. The US Embassy reports that Finance Ministry officials admit that the government relied on short-term borrowing to increase reserves. 25X1

The only good economic news Aridor could point to was the fact that unemployment did not rise. Aridor has contrasted in recent speeches Israel's 5-percent unemployment rate to the 10 percent or more recorded in the United States and some countries in Western Europe. The traditional reluctance to let redundant workers go and the invasion of Lebanon, which pulled workers out of the labor force last summer, were major factors in preventing the unemployment rate from rising. 25X1

Challenges Facing Aridor

Aridor has publicly stated that his most important short-term goal is reducing inflation, while improving the balance of payments is the most pressing longer term problem. He is constrained in dealing with these problems by an Israeli public that has come to expect an ever-increasing standard of living. In addition, the policy tools at his disposal are limited. 25X1

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Israel: Balance of Payments

Million US $

	1979	1980	1981	1982 [a]	1983 [b]
Civilian goods and services balance	−2,718	−2,214	−2,219	−3,450	−4,107
Exports	8,289	10,119	10,841	10,600	10,143
Goods	4,717	5,800	5,929	5,550	5,225
Services	3,572	4,319	4,912	5,050	4,918
Imports	11,007	12,333	13,060	14,050	14,250
Goods	6,916	7,454	7,459	7,600	7,750
Services	4,091	4,879	5,601	6,450	6,500
Self-financed military imports	250	250	−424	174	−104
Military import payments	1,420	2,018	1,483	2,295	1,930
US military assistance	1,170	1,768	1,907	2,121	2,034
Debt repayment (medium- and long-term)	893	1,025	1,152	1,525	1,635
Financial gap	**3,861**	**3,489**	**2,947**	**5,149**	**5,638**
Sources of financing	4,299	3,777	3,092	5,492	5,604
Unilateral transfers	1,400	1,471	1,521	1,550	1,666
US economic assistance	980	785	785	785	785
Israeli bonds	414	450	477	550	570
Other capital including net short-term borrowing	1,501	1,064	300	2,607	2,583
Net direct investment	4	7	9	0	0
Change in reserves	438	288	145	343	−34

[a] Estimated.
[b] Projected.

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One of the basic tenets of Israeli policy has always been that significant unemployment is unacceptable. In addition to the normal reluctance to incur the political costs of high unemployment, Israeli politicians have publicly stated their moral obligation to provide jobs for foreign Jews taking up permanent residence in Israel. Israeli officials also fear that a rising unemployment rate would generate major emigration. According to reporting from the US Embassy, this prospect is virtually unthinkable for a country built on the gathering of Jews from the Diaspora; it would also deplete Israel's most important resource—its well-educated labor force. 25X1

Aridor is also constrained in using traditional fiscal and monetary policies to right the economy. Defense, which currently accounts for 25 percent of the budget, probably is sacrosanct from budget cuts at this time because of the perceived threat from Syria and the continued expenditures required for the troops still in Lebanon. Another 35 percent of spending is allocated to legally mandated debt servicing and cannot be cut. Thus, budget cuts would have to come from the 40 percent earmarked for social services. Aridor would have to severely slash these expenditures in order to significantly

reduce government demand. This would run counter to one of the major functions of government in the view of the Israeli public—providing for an egalitarian society.

While raising income taxes is an option, we believe Aridor would probably conclude that a tax hike would only increase the Israeli proclivity for tax evasion because rates are already high. There is little the government can do to affect the sale of government bonds, with the exception of increasing their return. Monetary authorities cannot purchase and sell bonds as the Federal Reserve does. Israeli law requires that the Bank of Israel fund the government's budget deficit by printing money; thus, Bank of Israel officials cannot effectively control the money supply.

Since these traditional fiscal and monetary tools of government economic policy are of limited usefulness, Aridor has tried to get the Histadrut—the large labor organization—to agree to wage restraint. His goal is to prevent real wages from increasing and adding to inflationary pressures. Aridor first offered a 100-percent cost-of-living adjustment with productivity gains if the Histadrut would give up bargaining for additional wage hikes at the industry and plant levels. When that was not accepted, he then tried to get Histadrut agreement to a scheme whereby wages would be increased monthly by a fixed rate—Aridor talked about 5 percent.

Histadrut officials—knowing no Israeli government can afford to let unemployment rise—are not under pressure to moderate wage demands in order to protect jobs and have rejected Aridor's ideas. Aridor was reportedly forced by Begin to give in to the Histadrut on a public-sector wage agreement late last year and a new cost-of-living formula early this year after strikes led to piled-up garbage on the streets; he will have to wait until next year when current wage agreements expire to make another attempt at securing wage concessions. If Aridor implemented traditional austerity policies, he would quickly be confronted by politically unacceptable unemployment levels. The current 5-percent level is approaching the upper limits of tolerance. We believe an unemployment rate much above 7 percent would cause political problems for the Begin government.

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In our view, Aridor believes he has little choice but to try less orthodox economic policies—such as his shekel policy and cost-of-living adjustments set in advance. Since inflation shows no signs of abating—record increases occurred in two of the first three months of the year—Aridor will probably continue his policy of slowing the depreciation rate of the shekel. One Israeli official told a US Embassy officer that, since exports are not going to do well anyway, this is the time to use a slowed depreciation rate to fight inflation.

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1983: More of the Same

We believe economic activity will remain sluggish this year. Unless recovery in the United States and Western Europe is much more vigorous than we anticipate, exports will probably continue their downward trend—receipts in the first quarter of this year fell 10 percent compared with the same period in 1982. The government has come under considerable pressure from exporters for help, particularly for an end to the slower depreciation rate policy. Although a program to pay exporters to Europe 5 percent of the value added on their industrial goods has been announced and a $140 million export promotion fund has been established, the US Embassy reports considerable indecision over further moves to help exporters. Moreover, any government programs would at best have only a marginal impact on export earnings in the absence of recovery abroad.

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Wage gains in bargaining at the industry and plant levels, combined with the impact of the generous public-sector wage agreement signed late last year, will boost real wages by about 3 percent this year, in our view. Private consumption, however, will probably increase by a smaller amount than last

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year—not enough to offset export losses. While it would be difficult in any event for the stock market to repeat last year's gains, as a result of the "crash" in January, many Israelis will probably adopt a more cautious approach when making their spending decisions. In any event, much of the increased consumer demand will be met by imports, in large part because of the relatively lower price of goods purchased abroad because of Aridor's shekel policy. [redacted]

According to reporting from the US Embassy, manufacturers whose products compete with imports have been hit hardest by the slowed depreciation rate policy; as a result, we expect industrial output to remain sluggish. If businessmen begin to believe that the current slump may last for a while, they may begin to pare their payrolls. Some Israeli officials have admitted to US Embassy officers that the unemployment rate could go up to 7 percent this year. [redacted]

Declining exports, combined with increasing imports, will probably add another $700 million to the civilian goods and services deficit—pushing it to $4.1 billion. The deficit would have been even greater without falling oil prices. Since traditional sources of foreign exchange—US aid, transfer payments, and Israeli bond sales—are unlikely to increase enough to cover the increased deficit, the Israeli Government will be looking to commercial bankers for additional funds in order to avoid drawing down foreign exchange reserves. We agree with the US Embassy's judgment that one of the key unknowns facing Israeli officials is whether bankers are prepared to loan to Israel the amounts required, given the current uncertainties in international financial markets. [redacted]

Implications for the United States

Citing the country's poor economic performance, Israeli officials will undoubtedly press the United States for more aid on better terms. US aid is preferred to commercial loans because it carries better terms; a large share of US aid is in the form of grants and the repayment period on the loan portion is 30 years with a 10-year grace period. Israeli officials want to avoid drawing down foreign exchange reserves, according to statements made in a number of discussions with US officials, because they believe their access to commercial credit would then be reduced. [redacted] 25X1

The Israelis have already made a number of proposals to soften the terms of US aid and to increase the level. They have suggested: 25X1

- Increasing the forgiven portion of FMS (Foreign Military Sales) credits—a US House of Representatives subcommittee last week approved this for FY 1984.
- Allowing third countries to use a portion of their FMS credits for purchases of Israeli military equipment.
- Being permitted to use $200 million a year in FMS credits (ideally an addition to funds already available) for research and development of the Lavie, a new fighter plane. 25X1

In addition, the Israelis are likely to press for linkage of the level of US economic aid to debt servicing costs on previous US Government loans—the Senate last year approved a foreign aid bill for FY 1983 that endorsed this principle. Aridor will press even harder for additional aid if unemployment rises or insufficient commercial credit is available. Slowing the economy even more would be adopted only as a last resort. [redacted] 25X1

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Bolivia: The Cocaine Industry [redacted]

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During the last decade, Bolivia has emerged as a leading producer and exporter of coca paste and base. Sales gross over $1 billion annually; cocaine from Bolivian coca supplies roughly 40 percent of the 35 to 45 tons consumed each year in the United States. Although the government of Hernan Siles Zuazo has pledged to eliminate drug trafficking in Bolivia, he probably will be too occupied with consolidating his hold on power, fending off military and civilian critics, and grappling with Bolivia's current economic crisis to implement an effective antinarcotics program. [redacted]

Areas of Cultivation

Coca is grown primarily in two agricultural regions—the Yungas and the Chapare. We believe that coca grown in the Yungas region near La Paz accounts for about 40 percent of Bolivia's total coca leaf production. Coca from the Yungas is preferred by leaf chewers because of its sweeter taste and brings a higher price in the market than Chapare coca. [redacted]

Coca growing in the Chapare region near Cochabamba is a more recent phenomenon. Government-sponsored land colonization projects in the mid-1960s, which provided some roads and other improvements to encourage settlement, inadvertently spurred coca cultivation. The coca plant grows well in the poor Chapare soil and is resistant to many diseases and pests. Drug traffickers prefer the Chapare leaf to the Yungas because it is cheaper and has a higher cocaine content; as a result, the Chapare has replaced the Yungas region as the primary producer of coca in Bolivia. The US Mission in La Paz estimates that Chapare coca currently supplies approximately 60 percent of Bolivia's annual coca crop, nearly all of which is diverted to the illicit market. [redacted]

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Markets, Export Routes, and Methods

The coca crop may be processed in several ways. In smaller operations, the leaves are dried, pressed, packaged, and taken to local villages that serve as collection points. The routes used are often indistinct trails and small rivers. From the collection centers, dealers take the leaf to the major trafficking cities. Because there is no need to dry leaves destined solely for cocaine conversion, major growers and traffickers usually reduce their leaves to coca paste—a reduction of about 200 to 1 in volume—prior to shipment. Drug enforcement personnel report that many labs or "pozos" are located next to the fields so that leaves can be picked and processed immediately. [redacted]

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Coca paste and base are smuggled out of Bolivia by a variety of means. US Embassy reporting indicates that in the late 1960s and early 1970s most of Bolivia's illicit coca derivatives were shipped through Chile. After the fall of President Allende in 1973, however, the Chilean Government cracked down on narcotics trafficking and forced dealers to seek new routes and safer lab sites. Colombian trafficking organizations eventually moved into the vacuum left by the demise of the Chilean organizations and, according to estimates by the US National Narcotics Intelligence Consumer's Committee (NNICC), now control approximately 75 percent of the US cocaine trade. In 1981 the US Embassy in Bogota reported that almost 50 percent of Bolivia's illicit crop passed through Colombia on its way to US and other world markets. [redacted]

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Bolivian Coca Cultivation

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Cocaine Production

Coca Leaves	Dried coca leaves are covered with water and crushed into a paste. Kerosene or gasoline is added and the solution stirred for several hours. Sodium bicarbonate is added, the mix stirred well, and allowed to stand for six hours. Water and kerosene layers are then separated, and the kerosene discarded or reused. Strong ammonia is added to the water layer, precipitating cocaine base. The crude base is sun dried and transported to the crystal lab.
Crude Cocaine Base (Sulfato)	Cocaine base is dissolved in dilute sulfuric acid and boiled. It is cooled and filtered to remove solid impurities. Potassium permanganate solution is added until pink color remains. After standing four to six hours, the solution is filtered to remove solids. Ammonia water is added to precipitate purified cocaine base. Precipitate is washed with water and sun dried.
Purified Cocaine Base	Cocaine base is dissolved in ethyl ether and filtered to remove solid impurities. A mixture of ether, acetone, and concentrated hydrochloric acid is added to precipitate cocaine hydrochloride. The precipitate is dried carefully, using bright lights, and packaged for sale.
Cocaine Hydrochloride	

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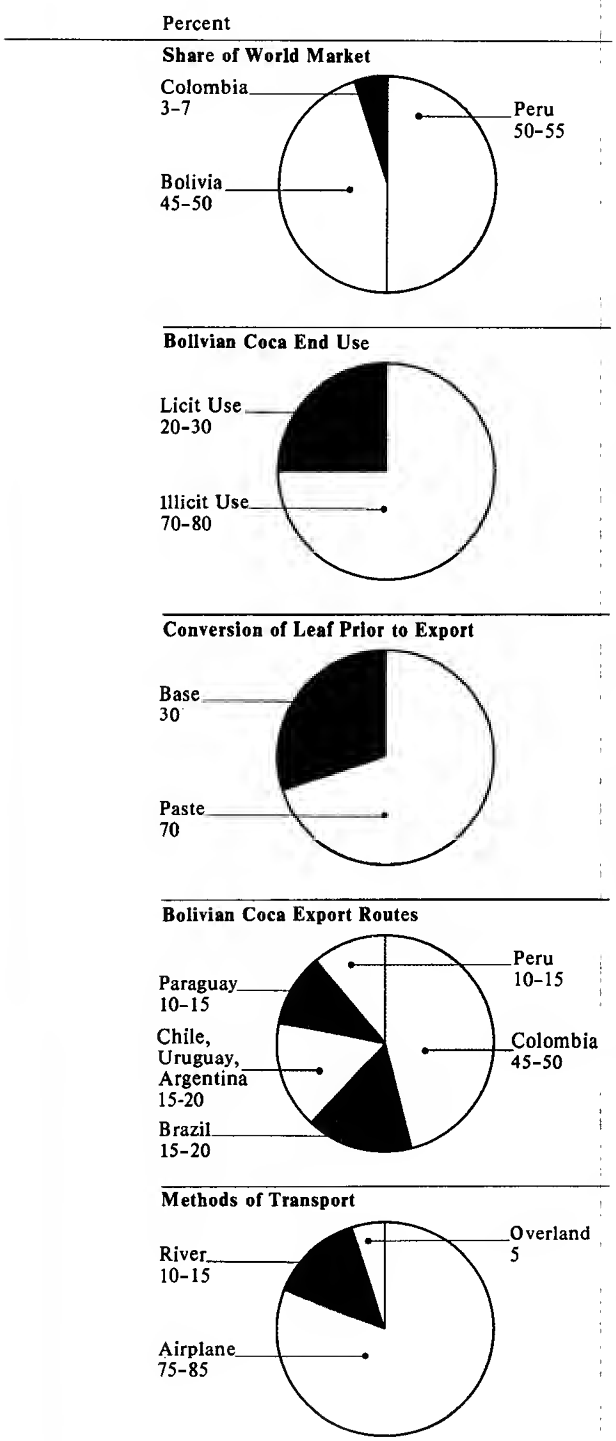
After processing in Colombia, the cocaine is packaged into kilo or multikilo lots and shipped to staging and transshipping areas in the Caribbean and Central America for final distribution to US retailers. Bolivian cocaine is also exported to consumers in Asia and Europe, although the United States remains the primary market—almost 40 percent of the 35 to 45 tons of coca consumed each year is from Bolivian coca. Cocaine's high value per unit weight makes shipment by air the most desirable form of transport. [redacted]

Economic Impact

The success of the Bolivian drug industry rests partially on the continuing depressed state of the Bolivian economy and the active cooperation of large segments of Bolivian society that share—some directly, most indirectly—in the profits. The current global economic slowdown has resulted in both weak demand and low prices for Bolivia's key mineral exports—tin, lead, and zinc. Bolivia's real GDP fell 1 percent in 1981—the worst performance since 1957—and final figures for 1982 show another 10-percent decline. Concurrently, inflation is about 150 percent for the first time since the 1950s. The official unemployment rate has climbed from 5 percent in 1979 to 10 percent in 1981 with underemployment now estimated at 20 percent. Under these conditions, many Bolivians have been quick to accept the coca bonanza as a way to break the cycle of economic hardship. [redacted] 25X1

The high prices paid the peasants for illicit coca encourage farmers to replace other crops with coca. According to local press reports, last December 500 kilograms of coca leaf sold for $1,000 in Bolivia. 25X1 [redacted] 25X1

Disposition of Bolivian Coca Leaf



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[redacted] 25X1 The process for converting leaf to paste is relatively simple, and the grower can double or triple his income if he converts his own leaf. Using standard reduction factors of 200 to 1, the grower's 500 kg of leaf—worth about $800 to $1,000—will yield approximately 2.5 kg of paste that the grower can sell for about $2,500. Each refinement increases the value of the product. Local press accounts and US Embassy reports cite the following prices per kilogram for Chapare-produced paste, base, and cocaine hydrochloride in Bolivia in 1982: paste $2,500; base $7,000 to $9,000; and cocaine hydrochloride $16,000 to $20,000. [redacted] 25X1

The US Embassy estimates that the income derived from the sale of coca leaf and its derivatives may be worth as much as $1.6 billion to the Bolivian economy—roughly one-third of Bolivia's GDP. Most of the money generated from the sale of coca leaf probably is retained in the local economy. However, income derived from the sale of paste, base, and cocaine HCL is harder to trace. Profits from drug sales are invested in real and personal property, deposited in offshore banks, and laundered through dummy corporations. Little information exists on this aspect of the drug trade, and it is difficult to project how much money is actually returned to Bolivia. Nonetheless, the coca/cocaine industry has become a vital part of Bolivia's economy—estimated income from the cocaine industry exceeded Bolivia's total legitimate exports valued at US $1.1 billion in 1980. [redacted] 25X1

Government Response

The government of Hernan Siles Zuazo has pledged to eliminate drug trafficking in Bolivia. We do not believe, however, that any Bolivian

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Government efforts to dismantle the well-entrenched cocaine industry will achieve more than marginal success over the next two or three years. Starting in the early 1970s, successive Bolivian governments have made sporadic attempts to suppress the drug trade, but even those programs pursued with US assistance have yielded minimal results. Although Siles has pledged his full cooperation in abolishing Bolivia's illicit drug industry, he has failed to take any effective antinarcotics action since taking office last October. Preoccupied with the economic situation and with protecting his coalition, Siles is reluctant to challenge the powerful narcotics industry. 25X1

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